No. 83-832

In the Supreme Court of the United States

OCTOBER TERM, 1983

HAROLD T. PAULSEN, ET UX., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Section 354(a)(1) of the Internal Revenue Code generally provides that "[n]o gain or loss shall be recognized if stock or securities in a corporation [which is] a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities * * * in another corporation [which is] a party to the reorganization." The question presented is whether the merger of a stock savings and loan association into a mutual savings and loan association, pursuant to which shareholders exchange their stock in the former for savings accounts in the latter, qualifies as a "reorganization" permitting tax-free, nonrecognition treatment of the gain realized on the exchange.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 20-32) is reported at 716 F.2d 653. The opinion of the Tax Court (Pet. App. 1-18) is reported at 78 T.C. 291.

JURISDICTION

The judgment of the court of appeals (Pet. App. 33) was entered on August 16, 1983. The petition for a writ of certiorari was filed on November 14, 1983. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Petitioners were shareholders of Commerce Savings and Loan Association (Commerce), a state-chartered, stock institution. On July 1, 1976, Commerce was merged into Citizens Federal Savings and Loan Association (Citizens), a federally-chartered, mutual institution (Pet. App. 22). Under the merger plan, each share of Commerce stock was

to be exchanged for a $12 deposit in a Citizens passbook savings account. Alternatively, Commerce shareholders could surrender their stock for Citizens certificates of deposit (CDs) at the same dollar exchange rate (Pet. App. 5, 22).

On July 1, 1976, petitioners owned 17,500 shares of Commerce stock with a tax basis, or cost, of about $57,000. In the merger exchange, they received Citizens savings accounts and CDs with a face amount of about $210,000 (Pet. App. 22). They thus realized a gain of $153,000. Petitioners did not report this gain as income on their 1976 tax return, taking the position that the merger was a "reorganization" and that the gain, accordingly, should not be currently recognized. Section 368(a)(1)(A) of the Code[1] defines "reorganization" to include "a statutory merger." Section 354(a)(1) provides that "[n]o gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in * * * another corporation a party to the reorganization." Petitioners contended that the Citizens savings accounts they received in the merger were the functional equivalent of "stock," since Citizens was a mutual institution, and since those accounts represented ownership interests in it.

On audit, the Commissioner determined that the merger was not a tax-free reorganization, and that petitioners were required to recognize gain, taxable at capital gains rates, in the amount of $153,000—the difference between the value of the savings accounts they received and their basis in the Commerce stock surrendered (Pet. App. 1-6). It is well established that a merger qualifies as a "reorganization" only if there is a "continuity of proprietary interest," *i.e.*, if the stockholders' ownership (equity) interest in the old corporation carries over to the new corporation, so that their position is substantially unchanged. *Pinellas Ice & Cold Storage Co.* v. *Commissioner*, 287 U.S. 462 (1933); *Le Tulle* v. *Scofield*, 308 U.S. 415 (1940); *Bazley* v. *Commissioner*, 331 U.S. 737 (1947). The ownership interest that the shareholders acquire in the new corporation, moreover, must be "definite and material" and must "represent a substantial part of the value of the thing transferred." *Helvering* v. *Minnesota Tea Co.*, 296 U.S. 378, 385 (1935). The Commissioner took the position that petitioners received no meaningful ownership interest in Citizens when they acquired the savings accounts. He viewed those accounts as constituting, not "stock," but a "hybrid interest, representing debt which is the equivalent of cash while, at the same time, having certain equity features" (Pet. App. 10). The Commissioner concluded that these equity features were not sufficient to satisfy the "continuity of proprietary interest" test, and that petitioners in reality had exchanged their position as stockholders of Commerce for a position as creditors of Citizens.

[1]Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended ("the Code" or "I.R.C.").

Petitioners sought redetermination of the resulting deficiency in the Tax Court, which ruled against the Commissioner (Pet. App. 1-18). Following *Capital Savings & Loan Ass'n* v. *United States*, 607 F.2d 970 (Ct. Cl. 1979), *West Side Federal Savings & Loan Ass'n* v. *United States*, 494 F.2d 404 (6th Cir. 1974), and *Everett* v. *United States*, 448 F.2d 357 (10th Cir. 1971), the Tax Court held that the savings accounts received by petitioners were "stock" for purposes of the corporate reorganization provisions, and that the exchange was accordingly a tax-free reorganization (Pet. App. 10-17).

The court of appeals unanimously reversed (Pet. App. 20-32), following its earlier decision in *Home Savings & Loan Ass'n* v. *United States*, 514 F.2d 1199 (9th Cir.), cert.

denied, 423 U.S. 1015 (1975). The court acknowledged that the savings accounts carried with them certain proprietary features, since petitioners—like Citizens' other depositors and borrowers—thereby obtained technical voting rights and the (rather speculative) right to share in the proceeds of a solvent liquidation (Pet. App. 25-28). The court of appeals concluded, however, that the debt features of the savings accounts "overwhelmingly predominate[d]" (Pet. App. 24); that petitioners' interest in Citizens was essentially that of creditors; and that the savings accounts did not "partake sufficiently of equity characteristics" to satisfy the "continuity of proprietary interest" test (Pet. App. 27). In holding that the merger was not a tax-free reorganization, the Ninth Circuit "recognize[d] that [its] decision conflict[ed] with [those] reached by" the Court of Claims, the Sixth Circuit and the Tenth Circuit. *Id.* at 31-32, citing *Capital Savings & Loan, supra, West Side Federal Savings & Loan, supra*, and *Everett, supra.*

ARGUMENT

1. The court of appeals correctly held that the merger of Commerce into Citizens was not a tax-free reorganization, and that petitioners were not entitled to defer recognition of the gain they realized. The savings accounts petitioners received plainly did not constitute "stock" pure and simple. Rather, those accounts represented a hybrid interest possessing both debt and equity characteristics. Thus, in order to determine whether the merger entailed the "continuity of proprietary interest" requisite to a "reorganization" under this Court's decisions, it was necessary to inquire whether the savings accounts' equity features were "definite and material" and "represent[ed] a substantial part of the value" of the stock petitioners surrendered. Applying this test, the court of appeals properly determined that there was no

continuity of proprietary interest here. *Cf. Southwest Natural Gas Co.* v. *Commissioner*, 189 F.2d 332 (5th Cir.) cert. denied, 342 U.S. 860 (1951).

Although petitioners, as account holders in Citizens, technically possessed the rights to vote, to share in profits, and to participate in liquidation proceeds, those rights, viewed pragmatically in the context of a mutual savings and loan association, did not constitute a substantial proprietary interest. Citizens' borrowers, as well as its depositors, had the right to vote, but it could scarcely be contended that the former possessed any "proprietary interest" in the association. Depositors' voting rights were "infinitely dilutable" by the addition of new customers (Pet. App. 27), and in practice were surrendered to management when the accounts were opened (*ibid.*). Although depositors had a nominal right to participate in profits, through distributions that Citizens styled "dividends," Citizens in practice paid a fixed, preannounced rate on all accounts, so that accountholders' "profit participation" was illusory. The "dividends" Citizens distributed were identical to interest paid by stock institutions; indeed, elementary economics indicates that they must be, for "[i]t is fanciful to suggest that depositors deciding where to put their money attach any weight to whether an institution is a mutual or a stock association" (Pet. App. 27-28). The "dividends" were treated as interest for federal tax purposes, both from petitioners' and Citizens' points of view (I.R.C. §§ 116(c)(1), 591), and thus stood in marked contrast to the true dividends petitioners previously received on their Commerce shares (Pet. App. 28). Finally, while petitioners acquired a notional right to participate in the proceeds of any solvent liquidation of Citizens, the solvent liquidation of a savings and loan association is such a remote contingency that "any theoretical value [such a right might have] reduces almost to the vanishing point." *Society for Savings* v. *Bowers*, 349 U.S. 143, 150 (1955).

In sharp contrast to the minimal proprietary features of petitioners' savings accounts, the debt characteristics of those accounts were overwhelming. Petitioners obviously regarded the accounts—as one would regard any checking or savings account—as the equivalent of cash. The accounts, unlike the Commerce stock, were subject to withdrawal by petitioners and to retirement at the will of Citizens, and thus in no sense represented a permanent contribution to the latter association's capital. And whereas petitioners' stock investment in Commerce was "at risk"—a hallmark of a true equity stake—their investment in Citizens was essentially risk-free, being represented by short-term savings accounts that were federally insured.

In short, while petitioners clearly had an equity interest in Commerce, they just as clearly received a creditor's interest in Citizens. Far from continuing the proprietary ownership they previously had, they essentially cashed their investment out. Because the merger thus failed to satisfy the "continuity of proprietary interest" test, it was not a "reorganization" as defined by the statute or by this Court, and petitioners' exchange was properly treated as a sale of their Commerce stock producing currently taxable capital gain.

2. Common sense fully supports the court of appeals' construction of the Code's reorganization provisions, for any other interpretation would produce anomalous results. If the instant merger were a reorganization, petitioners would receive a "carryover basis" in their Citizens savings accounts, *i.e.*, a basis equal to their basis in the Commerce stock they gave up. See I.R.C. § 358(a)(1). Since petitioners' basis in their Commerce stock was $57,000, they would receive a basis of $57,000 in cash of $210,000. This result would violate the rule, uniform throughout the Internal Revenue Code, that cash, when expressed in U.S. currency, always has a basis equal to its face value. See, *e.g.*, I.R.C. §§ 301(b), 358(a)(2), 362(c).

This result would also create serious practical and administrative problems. Every time petitioners withdrew money from their passbook savings accounts, they would be required to recognize gain. Since each withdrawal would represent (on petitioners' theory) a redemption of "stock," the character of the gain—*i.e.*, whether a dividend taxable as ordinary income, or capital gain—would have to be determined by testing each withdrawal for "dividend equivalency" under the Code's elaborate redemption rules. See I.R.C. § 302. And every time petitioners deposited money into their passbook savings accounts, they would have to keep the "new cash" (which would have a basis equal to its face value) separate from the "old cash" (which would have a carryover basis), in effect dividing the passbooks into sub-accounts and creating severe tracing problems. These anomalies are not a mere awkwardness. Rather, they point up the logical shortcomings of a position that entails giving cash a tax basis different from its face value.

3. While we believe that the court of appeals was correct in holding that the merger of Commerce into Citizens was not a tax-free reorganization, we agree with petitioners (Pet. 8-13) and with the court of appeals (Pet. App. 31-32) that the decision below squarely conflicts with the decisions of the Court of Claims in *Capital Savings & Loan, supra*, the Sixth Circuit in *West Side Federal Savings & Loan, supra*, and the Tenth Circuit in *Everett, supra*.[2] The question presented, moreover, has considerable administrative

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[2]Of those three cases, only *Everett* involved the tax consequences of a comparable merger at the shareholder level. The other two cases involved the tax consequences of a comparable merger at the corporate level, such as restoration to income of a previously-established bad debt reserve. In each case, however, the fundamental issue was the same—whether the merger was a tax-free "reorganization." Parallel consequences for the corporation and its shareholders flow automatically from that determination. Compare I.R.C. §§ 354-358 with I.R.C. §§ 361-362.

importance. The Internal Revenue Service advises that at least 671 similar cases, involving approximately $20 million in income taxes, are pending administratively or in the lower courts. Accordingly, we do not oppose the granting of the petition for a writ of certiorari.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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